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Expanding Health Flexible Spending Accounts to Reimburse Over-the-Counter Drugs: A Positive Move

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With the Medicare prescription drug coverage debate raging in Congress, national attention is riveted on just how much drugs cost. Prescription drugs often take center stage, but by some estimates more than 60 percent of the drugs bought each year are sold over-the-counter. (Devon M. Herrick, Brief Analysis No. 448, National Center for Policy Analysis (July 24, 2003), available at <http://www.ncpa.org>.) Recognizing this trend, the Treasury Department and the Internal Revenue Service in September reversed a long-held position that had previously barred tax-free reimbursement of nonprescription drugs from employer-sponsored health care flexible spending accounts ("health FSAs"). Beginning in 2003, employees may be reimbursed by their health FSAs for over-the-counter drug purchases. (Rev. Rul. 2003-102, 2003-38 I.R.B. 559 (Sept. 22, 2003).)

A health FSA is an employer-sponsored benefit plan that allows employees to set aside part of their pay on a pre-tax basis to apply toward health care expenses that are not covered by insurance or otherwise paid by the employer. As long as the reimbursed expenses qualify as expenses for the medical care of the employee, the employee's spouse or the employee's dependents, the Internal Revenue Code (the "Code") excludes the reimbursements from the employee's taxable income. (I.R.C. Section 105(b).) "Medical care" for these purposes means medical care as defined in Code Section 213(d), which includes "amounts paid ... for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." (I.R.C. Section 213(d)(1)(A).) Despite the broad wording of Code Section 213(d), the IRS has held specifically that "[a]mounts paid by an individual for medicines or drugs that may be purchased without a prescription of a physician are not ... deductible under [Code Section] 213." (Rev. Rul. 2003-58, 2003-22 I.R.B. 959 (June 2, 2003).) Before the IRS announcement in September, Code Section 105(b)'s specific reference to Code Section 213(d) had consistently been interpreted to mean that health FSAs could reimburse on a tax-free basis only those medical expenses that could be deducted under Code Section 213.

In announcing the new interpretation of Code Section 105(b), the Treasury Department and the IRS focused on recent trends in the pharmaceutical industry. "Since many prescription drugs have moved to the over-the-counter market, this action today makes paying for them a little bit easier to swallow," said Treasury Secretary John Snow in the press release announcing the change, available at <http://www.ustreas.gov/press/releases/js695.htm>. On a technical level, the government reached its new position by focusing on the absence of any express requirement in Code Section 105(b) that reimbursable expenses must also qualify as deductible expenses under Code Section 213. The government also noted that Code Section 105(b) does not prohibit reimbursement of nonprescription drugs. Rev. Rul. 2003-102 does, however, emphasize that reimbursable over-the-counter drugs and medicines must be for medical care, not "merely beneficial to the general health" of the employee, the employee's spouse or the employee's dependents. Following this approach, dietary supplements are expressly excluded from tax-free reimbursement.

Employers are not required to change the terms of their health FSAs to reimburse nonprescription drugs. Early surveys, however, suggest that most large companies will adopt the more generous rules beginning in 2004. (Washington Business Group on Health Survey (Oct. 1, 2003), available at <http://www.wbgh.com>).

As with most new regulatory actions, questions remain. The IRS in Rev. Rul. 2003-102 addressed specifically only antacids, allergy medicines, pain relievers, cold medicines and vitamins. But what about dual purpose items that may be beneficial to general health as well as having a medical purpose? Examples include baby aspirin taken by adults as a preventative measure, lactose intolerance aids, and herbal medicines. Employers must establish clear policies to inform employees what will and will not be reimbursed, but they must do so without the benefit of any detailed guidance from the IRS. What kind of documentation should employers require? Presumably receipts clearly indicating what was purchased will suffice, but again the IRS has not provided specific guidelines.

Finally, is this a positive step by the government? For employees who need drugs that were previously available only by prescription and typically covered under an employer's prescription drug plan, the overall trend toward over-the-counter drugs has created frustration and, in some cases, financial hardship. Although over-the-counter drugs may be much less expensive than prescription drugs in general, they still may be more expensive than the low co-payment an employee was comfortable paying. Extending health FSA coverage to nonprescription drugs at least mitigates the increased financial burden on such employees. For employers struggling to maintain health insurance for their employees, this expansion of the health FSA rules costs nothing for the employers to add but gives employees a true benefit. It is a rare government move that has such an overall positive impact.